Testamentary Trusts

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What is a Testamentary Trust?

A Testamentary Trust is any type of trust created by a Will. However, when we say "testamentary trust" we are generally referring to a discretionary trust in a Will.

It is similar to a standard family trust but it is established by the terms of a Will when a person dies.

What are the main benefits of a Testamentary Trust?

It can provide asset protection and reduce tax.

How does it reduce tax?

A testamentary trust allows the person who controls it to split the income generated by the trust between family members who are on lower tax rates.

Importantly, children who receive income from a testamentary trust are not taxed at penalty rates, which applies to other types of trusts. This also means that children can utilise the 'tax free threshold' and receive up to $18,200 of income per year from a testamentary trust without paying any tax (based on resident tax rates for the year ending 30 June 2024).

Case study

Melanie dies leaving her spouse John with three children, Sam, Mike and James, who are all minors with no income.

Melanie's main assets in her name comprise an investment property and a life insurance policy with a total value of $2,000,000.

John is a property developer earning $200,000 that year, so any further income received by him will be taxed at the highest marginal tax rate of 47%.

Without a Testamentary Trust

John receives the $2,000,000 left to him by Melanie.

John invests the life insurance proceeds and leases the investment property to generate a combined income of $120,000 in the first year.

John would incur tax of $56,400 on that income. After tax, John is left with **$64,600**.

With a Testamentary Trust

In this scenario, Melanie's Will creates a Testamentary Trust that is controlled by John.

The assets are transferred to the Testamentary Trust and produce the same return of $120,000.

The income is allocated as follows:

	Income distribution	Tax paid
Sam	$40,000	$4,547
Mike	$40,000	$4,547
James	$40,000	$4,547
Total tax paid		**$13,641**

After tax, the family is left with **$106,359**.

This simple case study illustrates that by using a Testamentary Trust, just in one year, John can save $41,759 in tax!

Over a five-year period, the tax savings could be over $200,000.

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What to do with this money

Income in a Testamentary Trust that is allocated to children does not need to be paid to those children but can be applied instead for their expenses including education and health.

Asset protection

- **Protecting from creditors**

As the assets of a Testamentary Trust are held for the beneficiaries and not held in the personal names of the beneficiaries, they are protected from creditors and bankruptcy.

Taking the example set out above, imagine John's latest property development has failed. His lenders, clients and the tax office are all seeking payment from John's company. As a Director, John could be personally liable.

Melanie's estate assets do not belong to John personally as they are held in a Testamentary Trust. Therefore, those assets remain protected and kept in the family.

- **Protecting from divorce**

In some circumstances, Testamentary Trusts may protect an inheritance if one of the beneficiaries faces a relationship breakdown, although they are not bulletproof from Family Law Court orders.

By careful planning of the terms of the Trust and ensuring the Trust is established and used in the right way, it can be much more difficult for a former partner to access funds held in a Testamentary Trust.

- **Protecting vulnerable family members**

As you can appoint any person or company to manage a Trust on behalf of the beneficiaries, Testamentary Trusts can also provide ongoing protection for young, vulnerable or irresponsible beneficiaries, such as children with addictions, poor spending habits or cognitive impairments.

You can appoint someone to indefinitely control the Trust on behalf of the beneficiary or co-control the Trust with the beneficiary and if appropriate, select an age at which your child will take over control of the trust.

Do it properly

If you are going to establish a Testamentary Trust in your Will, it is critical that you obtain proper legal and tax advice.

A Testamentary Trust can be a fantastic tool for wealth preservation, protection and financial planning. However, if implemented incorrectly or without thought, the benefits afforded by Testamentary Trusts can be missed and other unanticipated problems may arise.

To discuss how a Testamentary Trust can benefit you and your family, please contact our Estate Group on (03) 8600 8885.

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